COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

AN ADJUSTMENT OF THE ELECTRIC RATES, TERMS, AND CONDITIONS OF KENTUCKY UTILITIES COMPANY	)))	CASE NO. 2003-00434

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O R D E R

Kentucky Utilities Company ("KU"), a wholly owned subsidiary of LG&E Energy LLC ("LG&E Energy"),[1] is an electric utility that generates, transmits, distributes, and sells electricity to approximately 478,000 consumers in all or portions of 77 counties in Kentucky.[2]

BACKGROUND

On November 24, 2003, KU filed a letter giving notice of its intent to file an application for approval of an increase in its electric rates to produce additional annual revenues of $58,254,344, an increase of 8.54 percent. On December 29, 2003, KU filed its application which included new rates to be effective January 31, 2004 and proposals to revise, add, and delete several tariffs applicable to its electric service. To determine the reasonableness of the request, the Commission suspended the proposed

[1] LG&E Energy is a Kentucky limited liability company and is an indirect subsidiary of E.ON AG, a German multi-national energy corporation.

[2] Operating under the name of Old Dominion Power Company, KU generates, transmits, distributes, and sells electricity to approximately 29,600 consumers in 5 counties in southwestern Virginia. KU also sells wholesale electric energy to 12 municipalities.

rates for 5 months from their effective date, pursuant to KRS 278.190(2), up to and including June 30, 2004.

KU's last increase in rates was authorized in March 1983 in Case No. 8624.[3] KU was required to reduce its rates as part of a rate complaint, Case No. 1998-00474,[4] in January 2000.

The following parties requested and were granted full intervention: the Attorney General of the Commonwealth of Kentucky, by and through his Office of Rate Intervention ("AG"); the Division of Energy ("KDOE") of the Environmental and Public Protection Cabinet; the Lexington-Fayette Urban County Government ("LFUCG"); the Kentucky Industrial Utility Customers, Inc. ("KIUC"); North American Stainless, L. P. ("NAS"); The Kroger Company ("Kroger"); the Kentucky Association for Community Action, Inc. ("KACA"); and the Community Action Council for Lexington-Fayette, Bourbon, Harrison and Nicholas Counties, Inc. ("CAC").

On January 14, 2004, the Commission issued a procedural schedule to investigate KU's rate application. The schedule provided for discovery, intervenor testimony, rebuttal testimony by KU, a public hearing, and an opportunity for the parties to file post-hearing briefs. On March 23, 2004, the AG, KDOE, KIUC, NAS, Kroger, KACA, and CAC filed their testimony. Also on March 23, 2004, the Commission granted KU's motion to consolidate into this case that portion of Case No. 2003-00396,

[3] Case No. 8624, General Adjustment of Electric Rates of Kentucky Utilities Company.

[4] Case No. 1998-00474, The Application of Kentucky Utilities Company for Approval of an Alternative Method of Regulation of Its Rates and Service.

relating to a new KU tariff for Non-Conforming Load ("NCL") customers.[5] On March 31, 2004, the Commission granted a joint motion by KU, the AG, the LFUCG, and KIUC to consolidate Case No. 2003-00335, an investigation of the Earnings Sharing Mechanism ("ESM") for KU, into this proceeding.[6] KU filed its rebuttal testimony on April 26, 2004.

On April 28, 2004, an informal conference was held with all parties to discuss procedural matters and the possible resolution of pending issues. Additional conferences were held on April 29, 2004 and May 3, 2004. The public hearing was convened on May 4, 2004,[7] at which time the parties indicated that significant progress had been made toward resolving many of the issues and they requested the hearing be delayed to allow additional discussions.[8] This request was granted and, on May 5, 2004, the parties announced a tentative agreement on two documents that resolved many of the issues. One document, titled "Settlement Agreement" ("ESM Settlement"), provided for the orderly discontinuance of the ESM. The other document, titled "Partial Settlement Agreement, Stipulation and Recommendation" ("Partial Settlement and Stipulation"), addressed all the remaining issues, including the NCL tariff, and resolved many but not all of the issues raised in KU's rate case.

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[5] Case No. 2003-00396, Tariff Filing of Kentucky Utilities Company and Louisville Gas and Electric Company for Non-Conforming Load Customers.

[6] Case No. 2003-00334, An Investigation Pursuant to KRS 278.260 of the Earnings Sharing Mechanism Tariff of Kentucky Utilities Company.

[7] For administrative efficiency, the public hearing for this case was held simultaneously with the hearing for the rate case filed by the Louisville Gas and Electric Company ("LG&E"). See Case No. 2003-00433, An Adjustment of the Gas and Electric Rates, Terms, and Conditions of Louisville Gas and Electric Company.

[8] Transcript of Evidence ("T.E."), Volume I, May 4, 2004, at 36-39 and 57-60.

Because the Partial Settlement and Stipulation did not resolve the issue of the appropriate revenue increase and depreciation rates for KU's electric operations, the hearing proceeded in the afternoon of May 5, 2004 with testimony being presented by KU and the AG. The hearing on those issues concluded on May 6, 2004. The parties subsequently finalized the ESM Settlement and the Partial Settlement and Stipulation and, on May 12, 2004, they filed the final versions of both documents.[9] During that hearing, the KDOE, KIUC, NAS, Kroger, KACA, and CAC withdrew their respective prefiled testimonies and responses to data requests on those testimonies. A hearing was then held on that date to receive testimony on the reasonableness of both documents.

On June 4, 2004, KU and the AG timely filed briefs in accordance with the procedural schedule. All information requested at the public hearing has been filed and the case now stands submitted for a decision.

ESM SETTLEMENT

KU previously submitted its calendar year 2003 ESM filing pursuant to its ESM tariff and it was docketed as Case No. 2004-00070.[10] In that filing, KU calculated its

[9] The ESM Settlement is attached hereto as Appendix A and the Partial Settlement and Stipulation is attached hereto as Appendix B. Both documents are incorporated into this Order as if fully set forth herein.

[10] Case No. 2004-00070, Kentucky Utilities Company's Annual Earnings Sharing Mechanism Filing for Calendar Year 2003.

2003 ESM billing factor to be 2.367 percent for April 1, 2004 through April 30, 2004, and 2.330 percent for May 1, 2004 through March 31, 2005.[11]

Under the terms of the ESM Settlement, the parties recommend that an Order be issued in Case No. 2004-00070 approving KU's 2003 ESM billing factors as filed and authorizing KU to bill them through March 31, 2005. KU would then collect and retain all this revenue. No later than May 2005, KU is to perform a final balancing adjustment to reconcile any over- or under-collection of the 2003 ESM revenues as billed from April 2004 through March 2005. Effective July 1, 2004, the ESM will be discontinued and KU will waive its rights to make any billings or seek any collections under its ESM tariff for its operations during the first 6 months of 2004.

The Commission has reviewed the ESM Settlement and finds that it constitutes a reasonable resolution of the issues related to the continuation of KU's ESM. When the Commission offered the ESM to KU in 2000, the intent was that this alternative form of regulation would provide sufficient incentives to KU to improve its performance while reducing the business risks inherent in over- and under-earnings. The management

[11] Under the provisions of its ESM tariff, KU is required to file a determination of a balancing adjustment to the current ESM billing factor, reflecting a true-up for any over- or under-collections experienced with the previous ESM billing factor. The revision in the 2003 ESM billing factor reflects the balancing adjustment for the 2002 ESM billing factor.

audit performed for the Commission concluded,[12] and KU confirmed in its own testimony, that the ESM has not incented KU to operate any differently than it would have without an ESM. In light of these results, the termination of the ESM as currently configured is reasonable. Therefore, the Commission will approve the ESM Settlement in its entirety. An Order confirming this will be issued in Case No. 2004-00070 in the near future.

The Commission notes that the ESM Settlement provides that nothing therein will bar a party from seeking, or the Commission from reinstating, an ESM which is designed to accomplish reasonable and valid regulatory objectives. While the Commission is now approving the termination of the current ESM because it did not achieve its intended purpose, we will take this opportunity to reaffirm our support for alternative rate-making mechanisms. KU is encouraged to continue considering alternative regulation, and, if it decides to propose one in the future, it should do so after seeking input from its customer representatives.

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[12] The Barrington-Wellesley Group, Inc. ("BWG") performed the ESM management audit and issued its final report on August 31, 2003. BWG determined that the ESM was an effective alternative to traditional cost of service regulation, although it did recommend some modifications to the current structure. The BWG report stated "However, it is the LG&E/KU management's position that the ESM program did not change management behavior. Management contends that LG&E and KU already had a strong continuous improvement program and that the ESM reinforced this behavior and added a regulatory mechanism for dealing with the ebb and flow of earnings over time." BWG Report at IV-1.

Therefore, the Commission will reduce KU's jurisdictional operating expenses by $51,989.

The Commission supports KU's efforts to reinforce the need for safety among their employees and encourages KU to develop appropriate safety programs. In future rate case, the Commission will reconsider the treatment of safety-related awards to the extent that KU can provide adequate documentation to show that these awards and other activities are integral components of a formal safety program.

During the test year, KU was a member of the Edison Electric Institute ("EEI") and allocated dues of $147,837 to its Kentucky jurisdiction. During the proceeding, KU was questioned about the activities of EEI funded by the membership dues. KU acknowledged that a portion of the EEI dues was associated with legislative advocacy and public relations and that it should be excluded for rate-making purposes. KU proposed that 31.55 percent of its EEI dues, or $46,643, be excluded.[97]

The Commission has reviewed the description of the various activities funded by the EEI dues,[98] and finds that the portion of the dues associated with legislative advocacy, regulatory advocacy, and public relations should be excluded for rate-making purposes. The description of regulatory advocacy appears to be a form of lobbying activity, which the Commission has not included for rate-making purposes in previous

[97] Post-Hearing Data Responses to Information Requested by the Commission Staff and the AG during Hearing held May 4-6, 2004, Item 11.

[98] Response to the Commission Staff's Third Data Request dated March 1, 2004, Item 40.

cases. These three categories account for 45.35 percent of the EEI dues.[99] Applying the 45.35 percent exclusion to the test-year jurisdictional EEI dues results in a reduction of $67,044.[100]

Based on these conclusions, the Commission has reduced jurisdictional miscellaneous expenses by $135,727.

Kentucky Income Tax Rate

KU determined that its jurisdictional federal and Kentucky income tax expense would be reduced by $16,152,919, based upon its proposed adjustments to jurisdictional revenues and expenses. KU's calculation reflected the use of the statutory federal income tax rate of 35 percent and the statutory Kentucky income tax rate of 8.25 percent.

The AG proposed that LG&E's effective Kentucky income tax rate for tax year 2002 of 7.87 percent should be used in all of KU's income tax and income tax-related calculations. The AG assumed that LG&E's effective tax rate would apply to KU, since both LG&E and KU pay the same Kentucky taxes.[101] The AG did not file any testimony in the KU case explaining his reasons for using the Kentucky effective income tax rate.

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[99] Post-Hearing Data Responses to Information Requested by the Commission Staff and the AG during Hearing held May 4-6, 2004, Item 11, page 2 of 3.

[100] Jurisdictional EEI dues of $147,837 times 45.35 percent equals $67,044.

[101] Response to the Commission Staff's First Data Request to the AG dated April 6, 2004, Item 4. KU's effective income tax rate for 2002 was 7.64 percent excluding credits and 7.35 percent including credits; See Response to the Commission Staff's Second Data Request dated February 3, 2004, Item 15(e)(2).